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AGENDA ITEM 9c

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Selection of International Developed/Emerging Markets Equity Managers for Spring-Fed Pool

II. PROGRAM: Global Equity

III. RECOMMENDATION: (1) Approve the following managers for inclusion in the International Developed and Emerging Markets Equity Manager Spring-Fed Pools:

Developed Managers

Martin Currie

OFI Institutional Asset Management

Principal Global Investors

Emerging Markets

Aberdeen Fund Management

Pyramis Global Advisors

Wellington Management

(2) Approve the use of annual review contracts for the managers to be included in the International Developed and Emerging Markets Equity Spring-Fed Pools.

IV. ANALYSIS:

Background

In the November 14, 2003 Investment Committee meeting, the Board approved the issuance of a Request for Proposal (RFP) with a Spring-Fed Pool feature for U.S. Equity Enhanced Indexing Managers. Subsequently, ten managers were placed in the Spring-Fed Pool. Of the ten managers, one currently manages assets for the Domestic External Equity Portfolio.

In the August 15, 2005 Investment Committee meeting, the Board approved the issuance of a RFP with a Spring-Fed Pool feature for International Developed and Emerging Markets Equity Managers. Subsequently, seven managers were placed in the International Developed Spring-Fed Pool and four managers were placed in the Emerging Markets Equity Spring-Fed Pool. Of the 11 managers, four currently manage assets for the International/Emerging External Equity Portfolio.

The RFP Spring-Fed Pool mechanism provides staff flexibility to actively manage the External Equity Portfolio (Portfolio). When initially establishing the Spring-Fed Pools, CalPERS opened the RFP searches to all interested managers.

The flexibility of the Spring-Fed Pool provides CalPERS the opportunity to refresh the Spring-Fed Pool when it finds managers that meet the original RFP qualifications, and most importantly, appear to have a competitive edge in managing assets relative to their benchmark. To take full advantage of the Spring-Fed Pool approach and identify prospective managers, staff continually monitors the universe of eligible candidates managing a variety of mandates. When prospective managers are discovered, staff can utilize the Spring-Fed Pool feature to incorporate those managers it expects will complement the existing Portfolio. This provides CalPERS the opportunity to evaluate managers after the initial RFP process has concluded. Each Spring-Fed Pool has a term of five years. The Pool for the U.S. Equity Enhanced Managers expires August 31, 2009. The Pools for the International Developed and Emerging Markets Equity Managers expire July 30, 2011.

Staff presented the Domestic and International Equity Annual Manager Reviews at the September 15, 2008, Investment Committee meeting and at that time noted the lack of prospective managers in the existing Spring-Fed Pools. This deficiency constrains staff's ability to improve the return of the Portfolio. Up to this point, staff has attempted to improve the performance of the Portfolio by either reducing the number of managers and/or reallocating assets among the existing managers.

Manager Search Process

On July 15, 2008, staff began the process of refreshing the Spring-Fed Pools by issuing the U.S. Equity Enhanced RFP and the International Developed and Emerging Markets Equity RFP.

Proposals were sent to seven firms that manage nine strategies. Of the nine strategies, eight were International and Emerging Markets. One additional proposal was sent out to a U.S. Equity Enhanced Equity manager that utilized a unique investment process for enhanced indexing. The proposals were evaluated by staff and Wilshire Associates as potential candidates for the Spring-Fed Pools. Additionally, staff utilized an independent provider of manager research, Mercer Investment Consulting, as a resource to identify and evaluate potential managers prior to beginning the Spring-Fed Pool refresh. A list of resources utilized by staff in the process of researching and evaluating the opportunity set for the Portfolio are shown below.

- External Databases (eVestment Alliance)
- Internal Manager Research
- Wilshire Associates
- Mercer Investment Consulting

Nine proposals were read and scored by staff, as per the criteria listed in the original RFP. The five scoring categories are as follows:

- Organization / Investment Professionals
- Investment Philosophy and Process
- Trading Process and Systems
- Performance
- Composite / Product Information

All seven firms presented their respective strategies to CalPERS staff and Wilshire Associates at the CalPERS office between October 15-17, 2008. The interviews were scored by staff in accordance with the interview criteria specified in the original RFP. The five scoring categories are as follows:

- Business Strategy
- Organization / Investment Professionals
- Investment Philosophy and Process
- Trading Process and Systems
- Risk Management

In order to determine the ranking among the nine strategies, the proposal scores and the interview scores were combined with the fee scores. Six of the nine strategies' scores ranked high enough to be included in the Spring-Fed Pools.

Of those six strategies, three are International Developed Equity and three are Emerging Markets Equity. Although staff issued the U.S. Equity Enhanced Pool Refresh RFP, the evaluation process did not warrant a staff recommendation for including additional strategies in the U.S. Equity Enhanced Indexing Pool.

Manager Analysis / Portfolio Construction

The six strategies considered for inclusion in the Spring-Fed Pools exhibit the portfolio characteristics sought by staff in an effort to complement the current manager lineup and provide suitable alternatives for the existing managers in the Portfolio. Two of the primary objectives in constructing the Portfolio are: 1) to enhance the return to risk profile of the Portfolio with every allocation or change in a manager, and 2) to mitigate style biases within the Portfolio. Some brief comments on each are below.

Enhance the Return to Risk Profile of the Portfolio

Staff seeks to maximize uncorrelated sources of alpha among its managers. The objective is for each manager to increase the return or lower the risk of the Portfolios. Evaluating the correlation among the managers (prospective and existing) is one means of evaluating the expected impact a manager will have on the return to risk profile of the Portfolio. Staff strives to add managers/strategies that are not highly correlated with one another or with the total Portfolio.

Incorporating managers with an expected low correlation to each other allows staff to build a more concentrated portfolio (fewer managers) that still provides the desired level of diversification. The historical excess return correlation analysis is used to compare each prospective manager relative to its respective Portfolio and to its peers. This analysis is shown in Tables 1 and 2.

Table 1 – Manager Excess Return Correlation Analysis *

| Recommended Manager International Spring-Fed Pool | Correlation to International Portfolio |
|---|--|
| OFI Growth | 0.09 |
| Martin Currie | 0.45 |
| Principal Core | 0.62 |
| Recommended Manager Emerging Markets Spring-Fed Pool | Correlation to Emerging Markets Portfolio |
| Aberdeen Value | 0.58 |
| Pyramis Core | -0.32 |
| Wellington Growth | -0.12 |

**Based upon 5 year correlations analysis through 9/30/08*

Table 2 – Manager Excess Return Correlation Analysis*

| Developed Managers | OFI | Martin Currie | Principal Core |
|---------------------------|-----------------|----------------------|-----------------------|
| OFI | 1.00 | 0.15 | 0.23 |
| Martin Currie | 0.15 | 1.00 | 0.63 |
| Principal Core | 0.23 | 0.63 | 1.00 |
| | | | |
| EM Managers | Aberdeen | Pyramis | Wellington |
| Aberdeen | 1.00 | -0.27 | 0.21 |
| Pyramis | -0.27 | 1.00 | 0.38 |
| Wellington | 0.21 | 0.38 | 1.00 |

**Correlation analysis based upon 5-year holding period through 9/30/2008*

Table 3 illustrates the three and five year active return along with the corresponding universe ranking for each manager being recommended for inclusion to the Spring-Fed Pools. Staff utilizes historical performance in this part of the evaluation process. Although staff recognizes past performance is not indicative of future performance, some information can be gleaned as to how each manager has fared relative to its peers over a moderate amount of time during different market environments.

Given these limitations, staff incorporates qualitative factors beyond manager quartile rankings in decisions to recommend managers for the Spring-Fed Pools. Staff does not select managers based solely on their quartile rankings given that manager styles go in and out of favor, but further analyzes the sources of the alpha to determine how it can complement the Portfolio. In some instances, a top-quartile manager may not necessarily be the best fit to the Portfolio. Additionally, there have been academic studies that examine the performance persistence of top decile managers. The research studies concluded there is no reliable information to glean from peer universe rankings that provide investors guidance in manager selection. Thus, staff focuses on issues like “stability of organization”, “stability of investment professionals”, and “adherence to investment discipline” with the overall objective for staff to construct a portfolio of managers which achieve the desired return and risk characteristics, using both quantitative and qualitative analysis.

Table 3 – Manager Performance Analysis through 9/30/2008

| Developed Managers | Annualized 3 Year Active Return* | Annualized 3 Year Universe Ranking** | Annualized 5 Year Active Return* | Annualized 5 Year Universe Ranking** |
|-------------------------------|---|---|---|---|
| OFI | 3.58 | Above Median | 2.89 | Above Median |
| Martin Currie | 2.49 | Above Median | 1.90 | Above Median |
| Principal Core | 1.68 | Above Median | 3.04 | Above Median |
| | | | | |
| Emerging Mkts Managers | | | | |
| Aberdeen | 5.12 | Above Median | 5.78 | Above Median |
| Pyramis | 1.59 | Above Median | 1.97 | Above Median |
| Wellington | 3.72 | Above Median | 3.39 | Above Median |

*Active return based upon specific manager benchmarks

**Universe rankings based upon manager gross return in eVestment Database.

As illustrated in Tables 1, 2, and 3, the majority of the recommended managers have historically shown to have relatively low correlations to their Portfolio and their peers and also exhibit above average excess returns. Additional individual manager analysis is shown in Attachment 2.

Mitigate Style Biases within the Portfolio

The Portfolio consists of managers whose portfolios exhibit core, growth, and value characteristics. Staff strives to mitigate style-biases within the Portfolio by rebalancing among the managers as the market favors certain investment styles based on the economic cycle. At this time, the international equity and emerging markets equity portfolios have distinct value biases that staff has been attempting to mitigate over the last several months. Refreshing the Spring-Fed Pools is expected to provide staff more flexibility in managing the style biases and risk exposures that often occur in the Portfolio. Figures 1 and 2 illustrate the style biases that exist within the International Developed Equity and Emerging Markets Equity Portfolios.

Figure 1 – International Equity Portfolio Structure - 12/31/2008

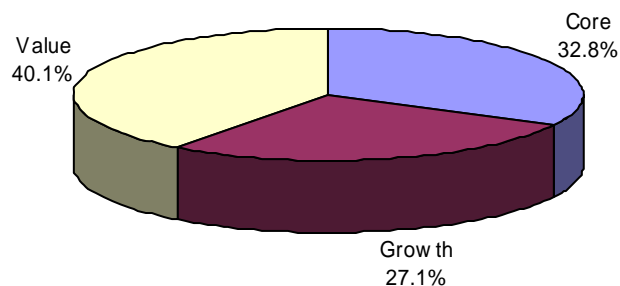
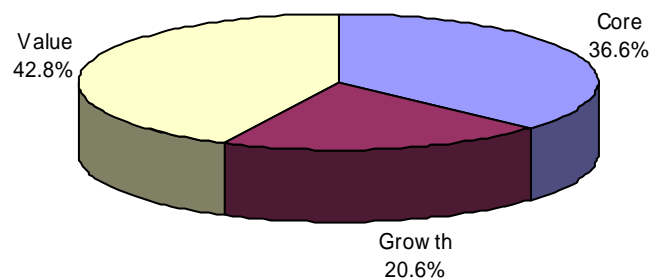


Figure 2 – Emerging Markets Equity Portfolio Structure – 12/31/2008



The value biases within the International Developed Equity and Emerging Markets Equity Portfolios have been detrimental to the performance of the Portfolio as managers with a value approach to investing have had a difficult time in the current market environment.

The majority of managers being recommended to the Investment Committee for inclusion into the International Developed and Emerging Markets Equity Pools have a growth bias to their stock selection and portfolio construction processes. In addition, these managers have shown the ability to be more adept at recognizing changes within the markets and nimble enough to incorporate these changes into their portfolios to generate performance. Including these managers in the Spring-Fed Pools is expected to be beneficial to managing the Portfolio.

Based on the results of the RFP process, staff and Wilshire Associates (see Attachment 1) recommend six firms for inclusion in the International Developed and Emerging Markets Equity Manager Spring-Fed Pools as shown below:

International Developed

Martin Currie (Intl Developed - Growth)
OFI Institutional Asset Mgmt (Intl Developed - Growth)
Principal Global Investors (Intl Developed - Core)

Emerging Markets

Aberdeen Fund Management (Emerging Markets)
Pyramis Global Advisors (Emerging Markets)
Wellington Management (Emerging Markets)

Wilshire's conflict disclosure letter is shown in Attachment 3.

Annual Review Contracts

Staff recommends the use of annual review contracts, which provide for an undefined duration, that are subject to a 30-day termination notice. This is consistent with the contracting procedure used for the existing external equity managers.

Funding

This recommendation does not commit CalPERS to fund any of the proposed managers, allowing staff to continue with its review of the External Equity Portfolio. Any potential or future funding of the managers in the International Developed/Emerging Markets Equity Manager Spring-Fed Pools will come from existing public equity assets.

V. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Adding more managers to the Spring-Fed Pool will increase the opportunity set of managers for Global Equity to select from to manage CalPERS assets with the expectation of enhancing risk-adjusted returns in this asset class. Allocation to managers from within the Spring-Fed Pool will incur a fee for services, however a performance based fee model will be used.

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